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Fallen Angels and the Received Wisdom

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Many individuals enter the investment business without preconceived notions, but the defect is soon corrected. The rookies' new colleagues are glad to provide them with received wisdom about the behavior of securities prices.

Few newcomers have the luxury of independently testing these precepts. They're simply overwhelmed with other duties that bear more importantly on their job tenure. Out of necessity, most neophytes put their trust in the experience of others.

Accepting things on faith can be an effective coping mechanism for practitioners in the early stages of their careers. Given their limited responsibilities, novices are not likely to do much damage by acting upon incorrect, untested propositions. As the years pass, however, the potential cost of applying mistaken principles rises. Unfortunately, so does the premium on the time of a successful investment professional. Rarely can a busy practitioner suspend other activities to investigate entrenched operating assumptions.

To remain forever captive to accepted, but unsubstantiated, hypotheses would be particularly oppressive for a born iconoclast like myself. Fortunately, as the head of a research department I can allocate a portion of our resources to examining Wall Street's sacred cows.

My group's recent study of the fallen angel hypothesis is typical of what happens when we scrutinize established notions about the financial markets.[1] The proposition we examined had long been promulgated but was almost completely untested. It rested on demonstrably incorrect premises and, when the evidence was in, proved to be a dubious money-making proposition.

To begin with a definition, a fallen angel is a corporate bond that was formerly rated investment grade (triple-B or higher) but has since been downgraded to speculative grade (double-B or lower). The widely accepted wisdom on these securities is that they trade below their inherent value. Institutional investors, so the story goes, reflexively sell bonds that fall below triple-B. They respond in such unthinking fashion either because of rigid investment guidelines or because they recoil from any association with low-quality assets. According to the fallen angel hypothesis, these noneconomically driven decisions create an opportunity for investors who are not constrained by ratings considerations.

It's easy to understand why the fallen angel story has such widespread appeal. What could be more gratifying than profiting at the expense of stodgy, unimaginative institutions? Our study indicated that the bargains were illusory, however. We found no evidence of bonds systematically falling to less than their intrinsic worth upon downgrading to the speculative category.

Remarkably, no one had studied the risk-adjusted returns of fallen angels prior to Edward I. Altman in 1991, even though we found references to the hypothesis dating back to the 1970s.[2] Over most of the horizons he tested, Altman found negative residuals for fallen angels, when compared with returns on an index of high-yield bonds.

In analyzing Altman's results, we wondered whether the conclusion might be different if each fallen angel were pitted against the specific rating category to which it had been downgraded, rather than a broad index of bonds ranging from double-B to triple-C. As it turned out, though, the picture did not improve when we measured double-Bs against the double-B index and single-Bs against the single-B index. In aggregate, our sample of all fallen angels in 1989 and 1990 produced a negative residual of 400 basis points during the 12 months following downgrading. Removing financial services companies from the sample made the fallen angel story look better, but did not produce a statistically significant positive residual.

To explain the unexceptional performance of the fallen angels, we next investigated the institutional rigidities that allegedly caused them to be undervalued. Far from being forced to dump downgraded issues, we found, "investment grade" mutual bond funds stated in their prospectuses that they used securities rated double-B or lower to increase their yields. Major pension plan sponsors told us that they left to their investment managers the decision to hold or to sell fallen angels. Nor were life insurance companies compelled to sell out when a bond was downgraded to less than triple-B, although their reserving requirements would

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ordinarily change when the rating fell.

We concluded that the fallen angel hypothesis, which had been handed down from one generation of practitioners to the next, had little basis in fact. The findings raised once again a question that frequently emerges from our research: "How do these dubious propositions get perpetuated?"

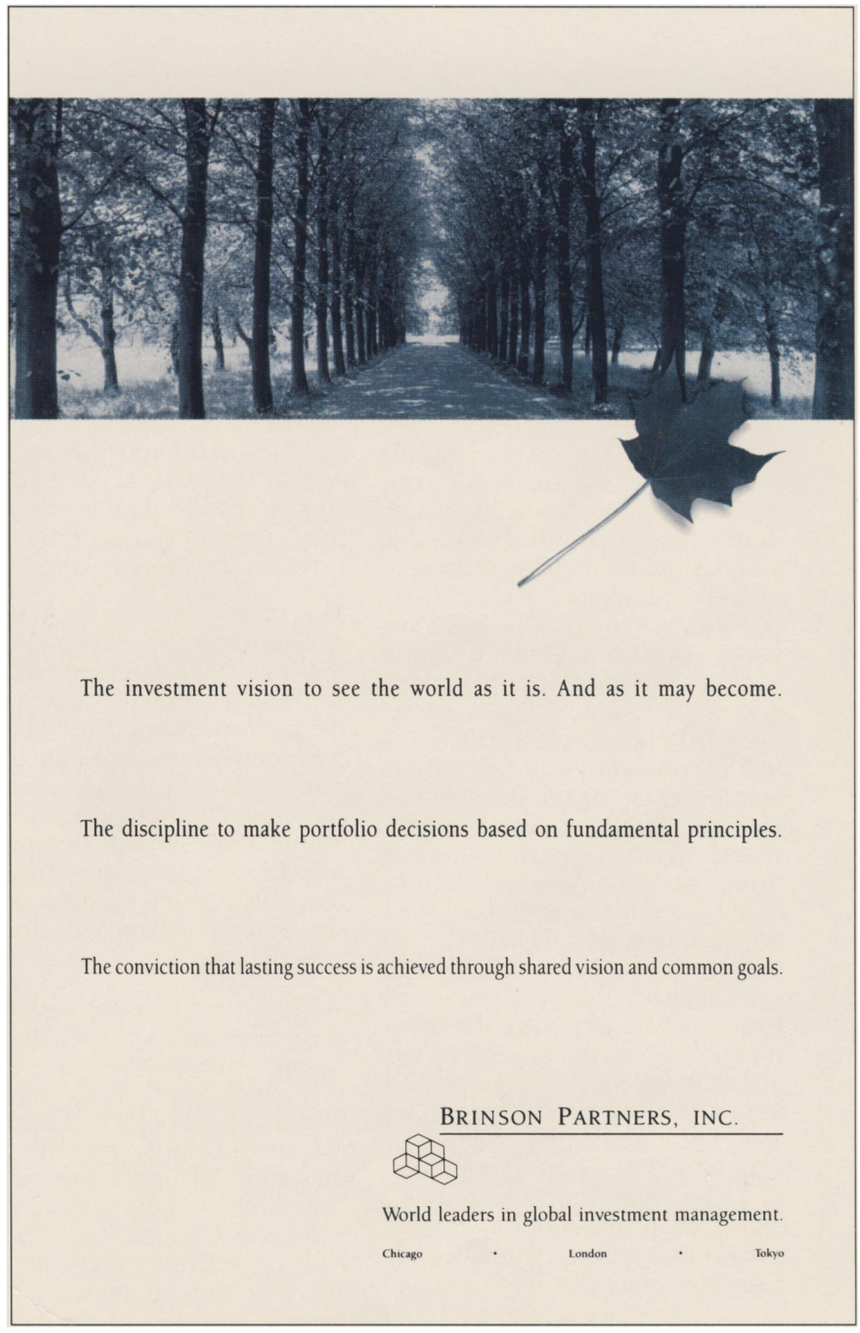
Part of the answer, I believe, involves a common error of perception. When an event happens to coincide with a preconceived notion, investors are likely to see it as a confirmation. This phenomenon is likely to occur in connection with fallen angels, since some issues do in fact outperform their rating peer groups. Contradictory evidence may escape investors' notice simply because they don't expect to see it.

A second reason for the persistence of unsubstantiated hypotheses is that practitioners are too busy to test everything. To the extent they have time for pure research, they're likely to focus on "hot" concepts like the January effect. Old, familiar ideas like the fallen angel hypothesis don't have the same sex appeal. Besides, everybody already "knows" they're correct.

A lot of remedial work remains to be done on cherished, yet unverified notions regarding securities price behavior. For the time being, the safest strategy is to treat all such trading rules as provisional, no matter how many years they've been around.

Footnotes

1. *M.S. Fridson and M.A. Cherry, "Are There Bargains in Fallen Angels?"* Extra Credit: The Journal of High Yield Bond Research *(Merrill Lynch & Co.), March/April 1992.*
2. *E.I. Altman,* Distressed Securities: Analyzing and Evaluating Market Potential and Investment Risk *(Chicago: Probus Publishing, 1991).*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